DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0251
Indiana Corporate Income Tax
For the Years 1989 through 1996

NOTICE: Under IC 4-22-7-7, this document is required to be published in the Indiana Register and is effective on its date of publication. It shall remain in effect until the date it is superseded or deleted by the publication of a new document in the Indiana Register. The publication of the document will provide the general public with information about the Department's official position concerning a specific issue.

ISSUES

I. Credit for Payment of Estimated Quarterly Tax.

Authority: IC 6-8.1-5-1(b).

Taxpayer argues that the Department of Revenue failed to properly credit it for a 1995 estimated quarterly payment purportedly made by means of an electronic funds transfer.

II. Computation Errors/Failure to Offset Liability.

Authority: IC 6-8.1-5-1(b).

Taxpayer maintains that the audit report failed to account for a credit contained in the audit report. In addition, taxpayer maintains that the audit report contains certain computational errors and omissions.

III. Proceeds from the Sale of Publishing Company – Gross Income Tax.

Authority: IC 6-2.1-1-2(a); IC 6-2.1-2-2(a)(1); IC 6-2.1-2-2(a)(2); Bethlehem Steel v. Indiana Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992); 45 IAC 1-1-19; 45 IAC 1-1-21; Black's Law Dictionary (7th ed. 1999).

Taxpayer argues that the Department of Revenue (Department) erred in finding that money received from the sale of a publishing company's Indiana distribution center was subject to the state's gross income tax. Alternatively, taxpayer argues the Department should not have imposed gross income tax against all of the proceeds attributable to the sale of this Indiana asset.

IV. Abatement of the Ten-Percent Negligence Penalty.

Authority: IC 6-8.1-10-2.1; IC 6-8.1-10-2.1(d); 45 IAC 15-11-2(b); 45 IAC 15-11-2(c).

Taxpayer requests that the Department exercise its discretion to abate the ten-percent negligence penalty.

DISCUSSION

Taxpayer is an out-of-state entity in the business of designing and manufacturing specialized equipment for both commercial and military use. During a number of years considered by the audit report, taxpayer owned a publishing company. That publishing company maintained a distribution center within the state.

The Department conducted an audit of taxpayer's business and tax records covering 1989 through 1996. The audit review determined that taxpayer owed additional Indiana corporate income tax. The taxpayer submitted a protest of the Department's decision, an administrative hearing was conducted during which taxpayer explained the basis for its protest, and this Letter of Findings Results.

DISCUSSION

I. Credit for Payment of Estimated Quarterly Tax.

Taxpayer argues that the audit report failed to properly credit it for a quarterly payment of estimated taxes. Taxpayer indicates that it made the 1995 estimated payment by means of an electronic funds transfer from its bank.

The rule is found at IC 6-8.1-5-1(b) which states that, "The notice of proposed assessment is prima facie evidence that the department's claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed assessment is made." Under IC 6-8.1-5-1(b), the proposed assessment is provided a rebuttable presumption that the amount of the assessment is correct. Taxpayer has the burden or demonstrating the assessment is incorrect.

Taxpayer has provided a copy of its own internal business records indicating that the quarterly payment was authorized and was actually made. Taxpayer has provided a copy of its bank statement indicating that the bank made the payment. Taxpayer has provided a copy of the bank's own records indicating that the payment was made. In addition, these same records indicate that a second payment of Indiana taxes – a 1994 extension payment – was transferred to the Department by the same means and was received on the same date as the uncredited payment. This second payment was received by the Department and was credited to the taxpayer's account.

The Department's records do not indicate that the 1995 quarterly payment was received but speculates that the 1995 payment was "probably refunded." There is no substantive evidence to support that conclusion.

The taxpayer has met its burden of demonstrating that – to the extent it failed to receive credit for the amount of the 1995 quarterly payment – the proposed assessment is incorrect. Accordingly, taxpayer is entitled to receive credit for the quarterly payment.

FINDING

Taxpayer's protest is sustained.

II. Computation Error/Failure to Offset Liability.

Taxpayer maintains that the audit report contains certain errors and omissions. Specifically, taxpayer indicates that it did not receive credit for an amount labeled in the audit report as "Funds to Offset Open Liability." In addition, taxpayer maintains that it was entitled to a refund of certain collection fees.

The Department's records indicate that the amount labeled as "Funds to Offset Open Liability" was refunded to the taxpayer on April 3, 2002. Included in that refund check were three of the disputed collection fees. The Department's records indicate that four of the collection fees remain unrefunded.

Under IC 6-8.1-5-1(b), the audit report – including such matters as the disposition of the amount labeled as "Funds Available to Offset Liability" – is presumed correct. Under that same provision, taxpayer has the burden of demonstrating that the assessments are incorrect.

Taxpayer raises questions which are essentially related to computation, accounting, and recordkeeping procedures. These questions are outside the purview of the administrative hearing process and not subject to satisfactory resolution in a Letter of Findings intended to address conflicting interpretations of tax law. Nonetheless, taxpayer has demonstrated that pursuant to IC 6-8.1-5-1(b), the questions it raises are not entirely frivolous or unfounded. Because there are no legal issues attached to these questions, and because taxpayer is entitled to a resolution of those questions, the audit division is requested to undertake a supplemental review of the specific claimed errors and make whatever corrections it deems appropriate.

FINDING

Subject to the results of the supplemental audit review, taxpayer's protest is sustained.

III. Proceeds from the Sale of Publishing Company – Gross Income Tax.

Until 1995, taxpayer owned a publishing company. The publishing company had numerous physical assets which included an Indiana book distribution center. The distribution center consisted of inventory, physical plant, and associated equipment. However, the publishing company also maintained inventory in 33 other states and plant/equipment assets in seven other states. The publishing company was headquartered at an out-of-state location. Taxpayer maintains that the publishing company's commercial domicile was in that same out-of-state location as its original headquarters.

In 1995, taxpayer sold the publishing business resulting in what taxpayer modestly describes as a "substantial profit."

Taxpayer reported the proceeds from the sale of the Indiana inventory in its tax calculation. Initially, it failed to report the proceeds from the Indiana plant/equipment assets. The Indiana audit corrected that oversight, and taxpayer does "not dispute that these proceeds [plant/equipment] belong to Indiana."

What is at issue is the "substantial profit" taxpayer received. Taxpayer calculates the "substantial profit" as follows: Prior to the sale, taxpayer estimated it would receive a certain amount from the sale of the publishing company based upon the value of its physical assets. Strictly for purposes of illustration, taxpayer evaluated the publishing company's assets and determined that it would receive 10 million dollars from the sale. It did not receive 10 million; it received (again for purposes of illustration) 15 million dollars. Taxpayer describes the difference between the original estimated value of the company and the amount it received (5 million) as attributable to the publishing company's "goodwill."

Taxpayer maintains that none of the "goodwill" is attributable to the Indiana distribution center. Instead, it attributes the 5 million dollars to the "creative genius and business acumen that allowed [taxpayer] to get an 'extraordinary price' for the publishing division." According to taxpayer, none of the 5 million dollars is attributable to Indiana but that entire 5 million dollars is attributable to its own out-of-state location where the business decisions leading to the sale of the publishing company were made. Specifically, taxpayer "believe[s] that Indiana's connection to the goodwill transaction is modest" and that none of the proceeds from the sale of the publishing company's goodwill were Indiana gross receipts.

The audit disagreed finding that the proceeds from the sale of the plant, equipment, inventory, and a *portion* of the goodwill – which the audit described as "Indiana goodwill" – were subject to the state's gross income tax scheme and were taxable at the "high rate."

Essentially, taxpayer argues that there is no such thing as "Indiana goodwill" and only the proceeds from the sale of the Indiana inventory and the Indiana plant/equipment were subject to gross income tax.

Indiana imposes a gross income tax upon the entire gross receipts of a taxpayer who is a resident or domiciliary of Indiana. IC 6-2.1-2-2(a)(1). For the taxpayer who is not a resident or domiciliary of Indiana – such as taxpayer – the tax is imposed on the gross receipts which are derived from business activities conducted within the state. IC 6-2.1-2-2(a)(2).

For purposes of calculating a taxpayer's "gross income," IC 6-2.1-1-2(a) states that, "Except as expressly provided in this article, 'gross income' means all the gross receipts a taxpayer receives (1) from trades, businesses or commerce [and] . . . (3) from the sale, transfer, or exchange of property, real or personal, tangible or intangible."

The regulations explain further. 45 IAC 1-1-19 states the gross income includes "Receipts from the conduct of a trade or business situated and regularly carried on in Indiana, including activities incident thereto (such as the disposal of *capital assets* or other property acquired or used in carrying on such trade or business in Indiana)." (*Emphasis added*). The term "capital asset" is defined at 45 IAC 1-1-21 which states, in relevant part, that, "[T]he Department extends through this regulation the definition of capital assets to include all other assets which are not considered to be inventory or stock-in-trade, even though such assets are intangible in nature, i.e., stocks, bonds, patents, trademarks, notes, copyrights, *goodwill*, etc., or current in nature, i.e. disposed of within the tax year." (*Emphasis added*).

The term "goodwill" is defined as including, "a business's reputation, patronage, and other intangible assets that are considered when appraising the business." Black's Law Dictionary 703 (7th ed. 1999).

It is apparent that when a business is sold, the proceeds from the sale are subject to Indiana's gross income tax. It is equally apparent that those proceeds attributable to the value of the business's goodwill are also subject to gross income tax. Presumably, taxpayer would agree with the general proposition that if the publishing company was located entirely within this state, the value attributable to the publishing company's goodwill would plainly be subject to Indiana's gross income tax.

However, the publishing company's operation was spread out over numerous out-of-state locations. It is taxpayer's contention that the value of the goodwill is attributable entirely to one state; the taxpayer's own out-of-state commercial domicile. In support, taxpayer cites to Bethlehem Steel v. Indiana Dept. of State Revenue, 597 N.E.2d 1327 (Ind. Tax Ct. 1992). In that case, the court found that the gross receipts petitioner received from safe harbor lease transactions were not derived from an Indiana source and were not subject to gross income tax. Id. at 1336-37. However, taxpayer's situation is distinguishable from Bethlehem Steel. In that case, the U.S. Congress legislated certain investment credits to encourage businesses to invest in new machinery in order to alleviate a national recession. Id. at 1328 n.1. Because the petitioner (Bethlehem Steel) did now owe federal income tax during the relevant years, it took advantage of a provision allowing it to enter into a sale-leaseback agreement with another company by which it sold the tax credits to that out-of-state company. Id. at 1328. The Tax Court found that the money received from the sale of the tax credits was not subject to Indiana's gross income tax. Id. at 1336-37. The court found that the tax credits were entirely unrelated to the petitioner's Indiana location and the equipment found at that location. Id. at 1337. The court concluded that the income received from the sale of the tax credits was unrelated to Bethlehem Steel's Indiana operation.

However, the proceeds from the sale of the publishing company's goodwill are not analogous to the proceeds received from the sale of Bethlehem Steel's tax credits. The sale of the publishing company's goodwill was inseparable from the sale of the publishing company itself. Taxpayer could not have severed the publishing company's "goodwill" and sold it to the highest bidder because the goodwill was inextricably linked to the publishing company itself. The publishing company, its physical assets, and its goodwill went hand-in-hand unlike Bethlehem Steel which was able to sever the tax credits and market them to an out-of-state entity. After Bethlehem Steel sold its tax credits, its Indiana operation remained entirely unaffected. After taxpayer sold the publishing company, it had entirely rid itself of Indiana distribution center together with all the other assets of the publishing company. The day after Bethlehem Steel sold its tax credits, its Indiana steel operated continued as before because the tax credits were unrelated to the Indiana assets. The day after taxpayer sold the publishing company, it was entirely out of the book publishing business. The Indiana distribution center, the inventory, the equipment, the building, and the goodwill belonged to someone else.

The Department is unable to agree with taxpayer's contention that the goodwill was entirely attributable to its own out-of-state business acumen and creative genius. The goodwill – and its associated cash value – was part-and-parcel with the inherent value of the publishing company and its associated physical assets; a portion of that goodwill is inextricably linked with the publishing company's Indiana distribution center.

Nonetheless, taxpayer offers a related challenge to the audit's assessment of additional gross income taxes. It proposes that the portion of the goodwill the audit attributed to the Indiana distribution center is overstated.

There is no reasonable contention that the value of the publishing company's goodwill (the 5 million dollars in the example above) is entirely attributable to the Indiana distribution center. Clearly, the Indiana distribution center was but one cog in a large book publishing business. However, the audit calculated the value of the Indiana goodwill "by taking the percentage of Indiana assets at cost (inventory, PPE and plant) and multiplying the percentage times the sale price of [publishing company's] goodwill." In doing so, the audit concluded that approximately 44 percent of the publishing company's goodwill was attributable to the Indiana distribution center.

Taxpayer challenges the 44 percent calculation on the ground that the publishing company's sales within the state of Indiana were relatively minor when compared to the publishing company's sales to other states. Instead, the majority of the publishing company's book sales were to larger and more populous states.

The Department is unable to accept the contention that the value of the publishing company's in-state goodwill should be based upon the amount of book sales made to the various states. Having found that the value of the goodwill was part-and-parcel with the value of the publishing company itself, the method used by the audit to attribute the Indiana goodwill appears entirely reasonable. The audit used a method of comparing the in-state and the out-of-state goodwill based upon the publishing company's in-state and out-of-state assets. After determining that 44 percent of the publishing company's buildings, equipment, and inventory were found within this state, it is not unreasonable to conclude that 44 percent of the publishing company's goodwill is associated with the assets contained within this state. Taxpayer would parcel out the goodwill based upon the percentage of in-state and out-of-state book sales. Such a method would be logically defensible if the taxpayer had sold the publishing company's customer list or its sales network. However, such is not the case because taxpayer sold the publishing company in its entirety. The buyer did not purchase and did not acquire the publishing company's past sales history; the buyer acquired the publishing company lock, stock, and barrel. The Department concludes that the audit's method of attributing the in-state goodwill of the publishing company to the in-state assets of the publishing company was neither unreasonable nor unwarranted.

FINDING

Taxpayer's protest is respectfully denied.

IV. Abatement of the Ten-Percent Negligence Penalty.

The audit assessed a ten-percent negligence penalty against the tax deficiency owed. Taxpayer argues that the penalty is unjustified because it exercised reasonable caution, care, and diligence in determining its Indiana tax liability. In addition, taxpayer maintains that a certain amount of the deficiency was attributable to legitimate but conflicting interpretations of the tax laws.

IC 6-8.1-10-2.1 requires that a ten-percent penalty be imposed if the tax deficiency results from the taxpayer's negligence. Departmental regulation 45 IAC 15-11-2(b) defines negligence as "the failure to use such reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." Negligence is to "be determined on a case-by-case basis according to the facts and circumstances of each taxpayer." Id.

IC 6-8.1-10-2.1(d) allows the Department to waive the penalty upon a showing that the failure to pay the deficiency was based on "reasonable cause and not due to willful neglect." Departmental regulation 45 IAC 15-11-2(c) requires that in order to establish "reasonable cause," the taxpayer must demonstrate that it "exercised ordinary business care and prudence in carrying out or failing to carry out a duty giving rise to the penalty imposed . . . ."

Taxpayer's position is that a certain amount of the additional assessment is attributable to simple oversights and to well-founded, but conflicting interpretation of the relevant tax law. In sum, taxpayer is of the opinion that it has acted in a thoughtful and conscientious manner in regard to its Indiana state tax liabilities.

The Department agrees that in any audit of a substantial and complex business there may be room for legitimate disagreements. Nonetheless, a substantial amount of taxpayer's own additional assessment stems from its failure to report the proceeds from the 1995 sale of the publishing company's Indiana distribution center. Although there may be room for disputing whether any of the proceeds attributable to the sale of the goodwill associated with that distribution center were subject to Indiana's gross income tax, there can be no dispute that the sale of the plant and equipment – valued in the millions of dollars – was subject to gross income tax. Although this omission may be blamed on taxpayer's "change in tax reporting software programs," the Department is unable to agree that such a substantial omission is indicative of the "reasonable care, caution, or diligence as would be expected of an ordinary reasonable taxpayer." 45 IAC 15-11-2(b).

FINDING

Taxpayer's protest is respectfully denied.

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